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TAX AND DEBT MANAGEMENT ASPECTS OF H.R. 1505 (THE FINANCIAL INSTITUTIONS SAFETY AND CONSUMER CHOICE ACT OF 1991)

Scheduled for a Hearing

before the

COMMITTEE ON WAYS AND MEANS

on May 29, 1991

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on May 29, 1991, to review the tax and debt management aspects of the Administration proposal to recapitalize the bank insurance system, modify the regulation of banks and other depository institutions, and expand allowable activities of banking corporations. The hearing will focus on H.R. 1505, the Financial Institutions Safety and Consumer Choice Act of 1991, introduced by Messrs. Gonzalez and Wylie on March 20, 1991. H.R. 1505 was jointly referred to the Committee on Banking, Finance, and Urban Affairs, the Committee on Energy and Commerce, and the Committee on Ways and Means.[1]

This document,[2] prepared by the staff of the Joint Committee on Taxation, provides a brief description of H.R. 1505 (Part I), the present tax rules applicable to banks and other financial institutions (Part II), and the principal tax and debt management issues within the jurisdiction of the Committee on Ways and Means that are raised by H.R. 1505 (Part III).

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[1] On May 23, 1991, the Subcommittee on Financial Institutions, Regulation and Insurance forwarded H.R. 1505, as amended, to the full Committee on Banking, Finance and Urban Affairs.

[2] This document may be cited as follows: Joint Committee on Taxation, Tax and Debt Management Aspects of H.R. 1505 (the Financial Institutions Safety and Consumer Choice Act of 1991) (JCX-7-91), May 24, 1991.

I. OVERVIEW OF H.R. 1505

On March 20, 1991, the Administration's proposal for recapitalizing and modifying the Federal Deposit Insurance System was introduced in H.R. 1505 (the Financial Institutions Safety and Consumer Choice Act of 1991), and was referred jointly to the Committee on Banking, Finance, and Urban Affairs, the Committee on Energy and Commerce, and the Committee on Ways and Means. In general, the proposed legislation would (1) significantly modify the regulation of financial institutions, (2) reform the deposit insurance system, (3) provide for the infusion of funds into the bank insurance system, and (4) expand the powers of banks.

A. Modification of Regulation of Financial Institutions

The proposed legislation would create a new agency within the Treasury Department, to be known as the Office of Depository Institutions Supervision, which would oversee the operations of Federally chartered banks, savings and loan associations, their holding companies and their subsidiaries. This new agency would perform the regulatory functions now performed by the Office of the Comptroller of the Currency and the Office of Thrift Supervision. The bill would amend the Internal Revenue Code to reflect the change in names to be made by the bill.

State-chartered banks, their holding companies and subsidiaries would be supervised by the Federal Reserve. Except for exemptions granted by the Federal Deposit Insurance Corporation (FDIC) to well-capitalized banks, all State-chartered banks and their subsidiaries would be prohibited from engaging in activities in which Federally-chartered banks could not engage.

The proposed legislation would impose new criteria for examining banks based on the capital level and size of the bank. The FDIC would retain its authority to examine insured banks. In general, the FDIC would be required to make an on-site examination at least once each year (once each 18-months in the case of small well-capitalized banks). The FDIC would be granted the power promptly to take over any bank that is poorly capitalized. Corrective action could include cuts in dividend rates.

Under the bill, credit unions would remain separately regulated and insured by the National Credit Union Administration (NCUA). However, the bill would provide that the Director of the Office of Depository Institutions Supervision would be one of members of the Board of Directors of the NCUA.

B. Reform of the Deposit Insurance Program

Insurance limits

Under the bill, individual depositors would be covered by Federal deposit insurance to a maximum of $100,000 per individual per institution, plus an additional coverage of $100,000 per individual per institution for retirement savings (e.g., IRAs). The bill would enforce this limitation by requiring that all bank accounts (including non-interest bearing accounts) insured by the FDIC be identified by account owner's taxpayer identification number (i.e., the individual's social security number) or employer identification number. In addition, the FDIC would be required to conduct a study on the feasibility of implementing a system of deposit insurance based on a nationwide limitation in deposit insurance for each depositor, utilizing the taxpayer identification number to identify each depositor in the deposit insurance system.

Under the bill, assets held in a revocable trust and certain escrow accounts would be aggregated with other deposits of the grantor of the trust. Irrevocable trusts would be treated under the bill as separate beneficiaries with each trust eligible for $100,000 of insurance.

The bill generally would deny so-called "pass-through coverage" so that entities with multiple beneficiaries (e.g., pension trusts) would be insured only to a maximum of $100,000, instead of $100,000 per beneficiary that is provided under present law. The bill would deny pass-through coverage to bank investment contracts (BICs). Under a special rule, an exception would be provided for self-directed defined contribution pension plans (e.g., Keogh plans), but these amounts would be combined with other retirement amounts of that insured individual as part of that individual's $100,000 insurance limitation for retirement benefits. The bill would retain pass-through coverage to State and local government pension plans (under Code sec. 457).

The bill would provide that insurance would not be provided to brokered deposits unless extending coverage to brokered deposits would lower the costs to the FDIC of providing insurance coverage to depositors of a problem bank. In order to minimize insurance risks, undercapitalized banks would not be permitted under the bill to solicit deposits by offering interest rates significantly higher than other insured institutions in the normal market area. The bill would deny insurance to foreign deposits.

Uninsured deposits of large banks ("Too big to fail")

The FDIC would be explicitly prohibited by the bill from

providing insurance to uninsured deposits unless (1) the FDIC finds that coverage of all accounts would be less costly than paying off only insured accounts or (2) the Federal Reserve Board and the Treasury Department find that failure to protect all depositors would pose a "systemic risk."

C. Infusion of Funds into the Bank Insurance Fund of the Federal Deposit Insurance Program

FDIC borrowing authority

The bill would grant the FDIC the authority to borrow up to $25 billion from the Federal Reserve System.[3] The stated purpose of such loans would be to fund existing losses of insured institutions. Such loans are to bear interest equal to rates on Treasury securities with comparable maturities and must be secured by dedicated increases in bank insurance premiums in amounts sufficient to service and retire the debt in accordance with its terms. This borrowing authority would be in addition to existing authority of the FDIC to borrow from the Treasury and the Federal Financing Bank. These loans would have the full faith and credit of the Federal Government but probably would not be subject to the Federal debt limit.

The bill also would provide that any borrowings by the FDIC from the Treasury under the $5 billion of borrowing authority of present law would be treated as an increase in the net worth of the FDIC. Consequently, any such borrowings could permit additional FDIC borrowings of $45 billion under the present law provision that permits FDIC borrowings of up to 9 times the FDIC's net worth. The stated purpose of these borrowings would be to provide the FDIC with adequate working capital. These loans also would be backed by the full faith and credit of the Federal Government.

Both of these borrowings would be exempt from the "pay-as-you-go" restrictions of the Omnibus Budget Reconciliation Act of 1990.

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[3] On May 7, 1991, the Subcommittee on Financial Institutions, Supervision, Regulation and Insurance of the Committee on Banking, Finance, and Urban Affairs forwarded H.R. 2094, as amended, to the full Committee on Banking, Finance and Urban Affairs. H.R. 2094 would provide for $25 billion of increased borrowing by the FDIC directly from the Treasury (for a total borrowing authority of $30 billion) and limits the amount of other direct borrowing that the FDIC would be able to do.

Insurance premiums

The bill would permit the FDIC to assess insurance premiums based on a bank's relative risk position. The risk position of a bank would be measured primarily by the ratio of the bank's capital to the bank's risk-weighed assets. Banks' insurance premiums (including any risk-based insurance premium) would be capped under the bill at $.30 per $100 of deposits.

D. Expanded Bank Powers

Types of permitted holding companies

The bill would grant additional powers to banks depending upon how the bank is owned. The bill would permit banks to be held in two different types of holding companies. In a "financial services holding company", a holding company (which is not itself a bank) could own banks, insurance companies, and brokerage houses. In a "diversified holding company", a bank could be held indirectly through a financial services holding company which, in turn, could be held by the diversified holding company so long as the bank is well-capitalized. The bill would amend the Internal Revenue Code to reflect the change in names of holding companies to be made by the bill.

Banks would be allowed to own subsidiaries that engage in certain activities, such as sales of insurance, subject to regulation of those activities in the subsidiaries.

Rules applicable to transactions between members of the same holding company ("firewalls")

The bill would put limits on loans by a bank to other members of that bank's financial services holding company group and would prohibit all loans to other members of that bank's diversified holding company group. Where a bank does not have adequate capital, the bill would require the financial services holding company either build up the bank's capital, sell the bank, divest themselves of the non-bank financial activities, or subject the holding company itself to the capital requirements and regulation applicable to banks.

The bill would grant regulatory authority to prevent use of insured deposits to gain a competitive advantage in other financial services activities over competing firms. The bill also would require strict disclosure to insure that customers of non-banking service companies are not misled due to the presence of an insured institution within the affiliated group that the non-banking services also are insured.

Interstate banking

The bill would permit a financial services holding company to purchase a bank in any State. The bill also would permit both Federal and State chartered banks to open initial branches in any State.

New types of permitted businesses

Under the bill, Federally-chartered banks would be permitted to sell directly insurance in any state where State-chartered banks in that State also are permitted to sell insurance. In other States, the bill would allow the sale of insurance through bank subsidiaries. As indicated above, the bill would permit insurance companies to be owned by a financial service holding company. The bill would require that sales of securities be done through an affiliate of a financial service holding company.

The bill would restrict participants of bank common trust funds to trusts and other assets held in a fiduciary capacity. Section 245(d) of the bill would amend the Internal Revenue Code to provide that transfer of all or substantially all of the assets of a common trust fund to a mutual fund by merger, conversion, reorganization, or similar transaction would be tax-free.

The bill generally would require that all real estate development and brokerage be done by an affiliate of a diversified holding company. Nonetheless, the bill would permit State-chartered banks to continue existing real estate brokerage activities.

II. PRESENT-LAW RULES RELATING TO BANKS AND OTHER FINANCIAL INSTITUTIONS

A. Use of Social Security Numbers to Enforce Deposit Insurance Limitation

Under regulations issued by the Federal Deposit Insurance Corporation (FDIC), deposits maintained in a bank insured by the FDIC are identified by the name of the individual account holder and are insured according to the "rights and capacities" in which they are held. There rights and capacities are set out in FDIC regulations.

The FDIC currently relies upon the insured depository institution's records when determining the amount of insurance available to a depositor. The FDIC presumes that funds are owned as shown on the "deposit account records" of the insured depository institution. If the FDIC determines that the deposit account records are unambiguous, those records are binding on the depositor. No other records are considered in determining legal ownership. "Deposit account records" are account ledgers, signature cards, CDs, passbooks, and certain computer records.

The Interest and Dividend Compliance Act enacted in 1983 requires that each interest bearing account include the owners taxpayer identification number. Institutions are required to report annually to the Internal Revenue Service the amount of interest earned by each depositor along with the depositor's taxpayer identification number. The FDIC does not rely on taxpayer identification numbers in determining deposit insurance coverage. Insurance is based upon actual ownership of the deposited funds and tax identification numbers are not necessarily conclusive as to ownership.

B. Tax Treatment of Commercial Banks

The Federal income tax rules that apply to most corporations under present law also generally apply to corporations that operate as commercial banks. In addition, however, certain special rules apply to banks. The most important of these special rules are: (1) the treatment of bad debt reserves of "small banks"; (2) the treatment of interest expense on debt used to purchase or carry tax-exempt bonds; (3) the taxation of foreign activities of U.S. banks and U.S. activities of foreign banks; (4) the treatment of gain or loss on securities as ordinary gain or loss; (5) the carryover period for net operating losses; and (6) the treatment of common trust funds of banks.

For purposes of some of the special rules, a "bank" generally is defined as a bank or trust company incorporated

and doing business under the laws of the United States (including the laws of the District of Columbia), or of any State, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is subject by law to supervision and examination by State, or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association (Code sec. 581). The basic definition is adjusted for some of the special rules.

1. **Bad debt reserves**

General tax rules applicable to all corporations

Under present law, taxpayers are permitted a deduction for any debt which is acquired or incurred in the taxpayer's trade or business which becomes wholly or partially worthless during the taxable year. This deduction generally must be computed under the "specific charge-off method"[4] under which specific bad debts may be deducted in the year in which they become worthless or partially worthless (Code sec. 166).

Special rules applicable to commercial banks

Under present law, large commercial banks are required to use the specific charge-off method for purposes of determining their deductions for bad debts. For this purpose, a bank is a large bank if, for any taxable year beginning after December 31, 1986, the average adjusted bases of such bank's assets (or the parent-subsidiary controlled group that includes such bank) exceeds $500 million (Code sec. 585(c)).

Banks that are not large banks may use the "experience method" in lieu of the specific charge-off method. Under the experience method, the taxpayer is allowed an addition to the reserve for bad debts that generally is an amount necessary

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[4] The Tax Reform Act of 1986 generally mandated the use of the specific charge-off method. Prior to the 1986 Act, a taxpayer could determine its deduction for bad debts under either the specific charge-off method or the "reserve method." Under the reserve method, a deduction was permitted, at the discretion of the Treasury Secretary, for a reasonable addition to a reserve for bad debts. When debts were determined to be totally or partially worthless, no deduction was allowed, but the amount of the bad debt was charged against the reserve (i.e., the reserve was reduced). Under the reserve method, a taxpayer then was allowed a deduction for an amount needed to increase the reserve to the appropriate level.

to increase the loan loss reserve at the close of the taxable year to a percentage of total loans outstanding equal to the average ratio of total bad debts in the current and 5 preceding taxable years to the sum of loans outstanding at the close of these years. However, if the adjustment leads to a larger loss reserve, the annual allowable addition is the amount necessary to increase the balance of the loan loss reserve to the balance of the reserve at the close of the taxpayer's last taxable year beginning before 1988 (or if the total amount of loans outstanding at the close of the taxable year is less than the loans outstanding at the close of 1988, a proportionate part of the loans outstanding at the close of the taxable year). Taxpayers may use an averaging period shorter than 6 years with the approval of the of the Treasury Secretary (Code sec. 585(b)).

If a bank maintaining a reserve for bad debts under the experience method becomes a large bank, such bank may no longer use the experience method, must begin to use the specific charge-off method, and is required to recapture the experience method reserve over a period of four years, beginning with the year of disqualification. The taxpayer must take at least 10 percent of the recapture amount in the year of disqualification, and take two-ninths, three-ninths, and four-ninths, of the remaining balance, respectively, into account in the next three succeeding years.[5] Alternatively, the taxpayer may elect to use the "cut-off method." Under the cut-off method, the taxpayer is not allowed deductions for additions to the bad debt reserve, but instead of recapturing the reserve, the taxpayer charges-offs against the reserve any losses on loans held by the bank as of the beginning of the year of disqualification. Bad debt deductions for loans entered into in the year of disqualification and thereafter are determined under the specific charge-off method (Code sec. 585(c)).

Bad debts generally are recognized, or are charged off against a reserve, only when some identifiable event has occurred that establishes their worthlessness. In the case of banks and other regulated financial institutions, Treasury regulations provide a conclusive presumption of worthlessness if such worthlessness is certified by the supervisory authorities of the institution (Treas. Reg. sec. 1.166-2(d)(1)).

For purposes of determining the bad debt deduction, a "bank" means any bank as defined under section 581 above,

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[5] Recapture is suspended for taxable years the bank is a financially troubled bank. A financially troubled bank is a bank whose balance of nonperforming loans exceeds 75 percent of the bank's equity for each quarter of the taxable year.

except for those institutions that qualify for the reserve method allowed for thrift institutions (discussed in detail below). In addition, the bank bad debt rules also apply to foreign banks, but only with respect to loans outstanding the interest on which is effectively connected with the conduct of a banking business within the United States.

2. Interest on debt used to purchase or carry tax-exempt bonds

General tax rules applicable to all taxpayers

Taxpayers generally are allowed to deduct the amount of interest expense paid or accrued within the taxable year (Code sec. 163(a)). However, present law disallows the deduction of interest expense on indebtedness incurred to purchase or carry tax-exempt obligations (Code sec. 265(a)(2)). The Internal Revenue Service and the courts have consistently interpreted the law to disallow an interest deduction only upon a showing that a taxpayer incurred or continued indebtedness for the purpose of acquiring or holding tax-exempt obligations.[6] They have employed various tests to determine whether a taxpayer has the prohibited purpose. In general, when a taxpayer has independent business or personal reasons for incurring or continuing debt, the taxpayer has been allowed an interest deduction regardless of his tax-exempt holdings. When no such independent purpose exists, and when there is a sufficiently direct connection between the indebtedness and the acquisition or holding of tax-exempt obligations, a deduction has been disallowed. Administrative practice provides that the purpose to purchase or carry tax-exempt assets will not be inferred if the average adjusted basis of the corporation's tax exempt obligations is 2 percent or less of the average adjusted basis of the corporation's trade or business assets.[7]

Special rules applicable to commercial banks

Banks and certain other financial institutions are denied a deduction for that portion of the bank's otherwise allowable interest expense that is allocable to tax-exempt obligations acquired after August 7, 1986. The amount of interest allocable to tax-exempt obligations generally is

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[6] See, Illinois Terminal Railroad Co. v. United States, 179 Ct. Cl. 674, 365 F. 2d 1016 (1967); Wisconsin Cheeseman, Inc. v. United States, 388 F. 2d 420 (7th Cir. 1968); and Rev. Proc. 72-18, 1972-1 C.B. 740 (1972).

[7] Sec. 2.05 of Rev. Proc. 72-18. The safe harbor is not available to dealers in tax-exempt obligations.

determined by multiplying the bank's otherwise allowable interest by a ratio, the numerator of which is the average adjusted basis of the bank's tax-exempt obligations acquired after August 7, 1986, and the denominator of which is the average adjusted basis of all the bank's assets (Code sec. 265(b)).

In addition, a bank is denied a deduction for 20 percent of the portion of the bank's otherwise allowable interest expense that is allocable to tax-exempt obligations acquired between January 1, 1983, and August 7, 1986. The amount of interest allocable to such obligations is determined based on a ratio similar to the one applicable to tax-exempt obligations acquired after August 7, 1986 (as described above) (Code sec. 291(e)(1)(B)).[8]

Certain qualified tax-exempt obligations acquired by a bank after August 7, 1986, are treated as acquired on or before such date (i.e., are subject to the 20-percent, but not the 100-percent, disallowance rule). A qualified tax-exempt obligation generally includes any obligation that is not a private activity bond and is issued by an issuer that reasonably anticipates that it will not issue more than $10 million of tax-exempt obligations (other than private activity bonds) during the taxable year (Code sec. 265(b)(3)).

For purposes of the 20- and 100-percent disallowance rules, interest expense is defined to include amounts paid with respect to deposits, investment certificates, or withdrawable or repurchaseable shares, whether or not designated as interest.

3. **Foreign activities of U.S banks and U.S. activities of foreign banks**

a. **Foreign income of U.S. financial institutions**

In general

The United States taxes U.S. persons on their worldwide income, including their income from sources outside of the United States. The foreign tax credit generally allows U.S. taxpayers to reduce the U.S. tax on their foreign income by the foreign income taxes they pay on that income. The foreign tax credit for any year may not exceed the following

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8 The ratio applicable to the 20-percent disallowance substitutes the average adjusted basis of the bank's tax-exempt obligations acquired between January 1, 1983, and August 7, 1986, in the numerator of the ratio applicable to the 100-percent disallowance.

amount, known as the foreign tax credit limitation: (a) pre-credit U.S. tax, multiplied by the quotient of (b) foreign source taxable income divided by (c) entire taxable income (Code sec. 904(a)).

U.S. persons that conduct foreign operations through a foreign corporation generally pay no U.S. tax on the income from those operations until the foreign corporation repatriates its income back to the United States. Deferral of U.S. tax on income of a controlled foreign corporation is not available, however, for certain kinds of income (sometimes referred to as "subpart F income") under the Code's subpart F provisions. When a U.S.-controlled foreign corporation earns subpart F income, the United States generally taxes the corporation's 10-percent U.S. shareholders currently on their pro rata share of the subpart F income.

One major category of subpart F income is foreign personal holding company income. For subpart F purposes, foreign personal holding company income generally consists of income such as interest, dividends, net gains from sales of property which does not generate active income, net commodities gains, net foreign currency gains, related party factoring income, and some rents and royalties.

Thus, current tax is imposed on the types of income typically earned by controlled foreign corporations that are banks or other financial institutions, subject to an exception if that income is subject to high foreign taxes. Tax deferral is available to a limited extent, however, for interest derived in a banking business in connection with certain export sales.[9]

Separate foreign tax credit limitations applicable to financial income

Income is divided into a number of separate categories for purposes of computing the limitation on allowable foreign tax credits; that is, credits for foreign taxes on income in each of these "foreign tax credit limitation categories" are subject to separate foreign tax credit limitations. Separate limitation categories, or "baskets," that are relevant to financial institutions include the categories for financial

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[9] To qualify for this export financing exception, interest must be derived in the conduct of a banking business from financing the sale (or other disposition) for use or consumption outside the United States of property which is manufactured, produced, grown, or extracted in the United States by the interest recipient or a related person, and not more than 50 percent of the fair market value of which is attributable to products imported into the United States. . .

services income, high withholding tax income, and passive income.

Separate limitation for financial services income

General definition of financial services income.--The separate foreign tax credit limitation for financial services income applies only to income received or accrued by any person that is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business. In such a case, financial services income includes income that (1) would also meet the definition of passive income (described above), (2) is export financing interest that is subject to a foreign withholding tax (or other gross-basis tax) of at least 5 percent, (3) is derived in the active conduct of a banking, financing, or similar business, (4) is derived from the investment by an insurance company of its unearned premiums or reserves that is ordinary and necessary for the proper conduct of its insurance business, or (5) is, with one modification discussed below, any income which would be insurance income under subpart F (Code sec. 904(d)(2)(C)).

The limitation for financial services income is so named to emphasize the broad range of income types to which the separate limitation applies. Treasury Regulations that describe this limitation refer to an entity that is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business as a "financial services entity" (Treas. Reg. sec. 1.904-4(e)(3)). Generally, an entity qualifies as a financial services entity for a taxable year if at least 80 percent of its gross income is active financing income.

In no event is income attributable to nonfinancial activity treated as financial services income. Thus, for example, income from data processing services or nonfinancial services or the sale of goods is not financial services income, even if the recipient satisfies the predominantly engaged test.

Export financing exception.--An export financing exception is provided to the separate limitation for financial services income (Code sec. 904(d)(2)(C)(iii)(III)). This exception is similar to the export financing exception to the separate limitation for passive income (described above), except that this exception applies only if the export financing interest is not subject to a foreign withholding tax of 5 percent or greater. For example, interest received by a U.S. finance company on loans made to foreign purchasers of inventory manufactured in the United States by, and purchased from, the finance company's manufacturing affiliate generally will qualify for the export financing exception.

Separate limitation for high withholding tax interest

Generally, for taxable years beginning after December 31, 1986, interest income (other than export financing interest) subject to a foreign withholding tax or other gross basis tax of 5 percent or more is designated "high withholding tax interest" and subject to its own separate foreign tax credit limitation (even if it otherwise would be financial services income).

A special transition rule applies, however, to certain interest on certain loans outstanding prior to or as of the close of the first taxable year of the taxpayer beginning after December 31, 1988, to any of 33 foreign countries (the "Baker 33") or to any resident of one of those countries for use in that country.

Under the transition rule, for a three-year period (i.e., taxable years beginning after December 31, 1986, and before January 1, 1990), foreign taxes paid with respect to interest on all loans to such foreign countries or residents (up to a limit based on 110 percent of the amount of qualified loans outstanding on November 16, 1985) are fully available to offset U.S. tax on certain foreign income (e.g., financial services income in the case of a taxpayer that is a bank) other than high withholding tax interest income. This transition rule thus grandfathers for the three-year period the interest on all loans to such borrowers that existed prior to November 16, 1985, and also prevents, during the three-year period, application of the substantive rules of the 1986 Act to taxes with respect to loans to such borrowers entered into in taxable years beginning before 1990, to the extent that the principal amounts of such loans, together with the principal amounts of any preexisting loans, do not exceed 110 percent of the principal amounts outstanding on November 16, 1985.

In each of the four years following this three-year period, an annually declining percentage of foreign taxes (80 percent in the first year, 60 in the second, 40 in the third, and 20 in the fourth) with respect to loans outstanding as of the close of the first taxable year of the taxpayer beginning after December 31, 1988 (again, subject to a limit based on 110 percent of the amount of qualified loans outstanding on November 16, 1985) may be used to offset U.S. tax on other foreign income.

Separate limitation for passive income

Passive income generally is any income of a kind which would be subpart F foreign personal holding company income (as defined in Code sec. 954(c)) if the taxpayer were a controlled foreign corporation, subject to certain exceptions described below (Code sec. 904(d)(2)(A)). Thus, passive

income for separate limitation purposes generally includes dividends, interest, annuities, rents, and royalties. Income that would otherwise meet the definition of both passive income and income in any of the other separate limitation categories is treated as income in the other separate limitation category and not as passive income (Code sec. 904(d)(2)(A)(iii)(I)). For example, interest income that meets both the definition of passive income and the definition of financial services income will be classified as financial services income.

The Code contains a mechanical rule excluding high-taxed income from the passive basket (the "high-tax kick-out") (Code sec. 904(d)(2)(A)(iii)(III)). For this purpose, high-taxed income is any income which would otherwise be passive income if the effective rate of foreign tax on the income exceeds the highest rate of U.S. corporate or individual tax (whichever applies) (Code sec. 904(d)(2)(F)).

Sourcing taxable income for foreign tax credit limitation purposes

Interest and dividend income generally are sourced on the basis of the residence of the payor. Compensation for services generally is sourced on the basis of where the services were performed. Income from the sale of personal property generally is sourced on the basis of the residence of the seller. Similarly, foreign currency gain or loss generally is sourced on the basis of the residence of the taxpayer or the qualified business unit of the taxpayer on whose books the asset, liability, or item of income or expense is property reflected. U.S. residents that derive income from sales of personal property attributable to an office or other fixed place of business maintained in a foreign country may generate foreign source income. However, the office rule only applies to U.S. residents if an effective foreign income tax of 10 percent or more is paid to a foreign country on the income from the sale.

In addition to sourcing items of gross income, items of deduction must be allocated and apportioned between income from U.S. and foreign sources in order to compute the foreign tax credit limitation. Two important deduction items for financial institutions are bad debt losses and interest expenses. Treasury Regulations to be issued in the future will provide that, for banks, a loss derived from the disposition or specific charge-off of a loan, in general, will be apportioned between U.S. and foreign source gross income on the basis of the relative values of the bank's U.S. and foreign assets (Notice 89-58, 1989-1 C.B. 699). Thus, if the particular loan that goes bad generated foreign source interest income, a portion of the loss on its disposition or charge-off may be apportioned to U.S. source income based on the composition of the rest of the bank's loan portfolio.

With respect to the allocation and apportionment of deductions for interest expense, generally money is treated as fungible and interest expense is viewed as attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid. For interest allocation purposes, all members of an affiliated group of corporations generally are to be treated as a single corporation (the so-called "one-taxpayer rule"). For this purpose, an "affiliated group" generally is defined by reference to the rules for determining whether corporations are eligible to file consolidated returns.

The statutory definition of affiliation for purposes of group-wide allocation of interest expressly provides for an exception to this general rule, however, in the case of certain financial institutions. Under this exception, the affiliated group for interest allocation purposes generally excludes any corporation, otherwise a member of the affiliated group for consolidation purposes, that is a financial institution (described in Code sec. 581 or 591), the business of which is predominantly with persons other than related persons or their customers, and which is required by State or Federal law to be operated separately from any other entity which is not a financial institution. A group or subgroup of two or more such institutions which are affiliated for consolidation purposes may, however, be treated as a single corporation for interest allocation purposes.

b. U.S. income of foreign financial institutions

Income from a U.S. branch

The United States Government asserts jurisdiction to tax the income of foreign persons that is "effectively connected" with the conduct of a trade or business in the United States, computed on a net basis, in the same manner and at the same rates as the U.S. income of U.S. persons (Code secs. §71(b) and 882). Most U.S. income tax treaties provide that the "business profits" (or in some cases, the "commercial and industrial profits") of an enterprise carried on by a resident of the treaty partner are not taxable by the United States unless the enterprise carries on a business through a permanent establishment situated in the United States. Moreover, the United States often agrees in treaties to tax only so much of the business profits of the enterprise as is attributable to the U.S. permanent establishment. Thus, a foreign bank or other financial institution that operates a branch or other office in the United States is subject to U.S. income tax on either its income attributable to the branch as a permanent establishment, or on its income effectively connected with its branch as a U.S. trade or business.

Interest income from a banking, financing, or similar business activity is treated as effectively connected if the loans on which the interest is received are attributable to the U.S. office through which the business is carried on. The loan is attributable to the U.S. office if that office actively and materially participated in soliciting, negotiating, or performing other activities required to arrange the loan (Treas. Reg. secs. 1.864-4(c)(5) and 1.864-6(b)(2)(ii)(b)). These rules hold generally for any income of a bank or other financial entity from stocks or securities. On the other hand, in the case of services, income generally is effectively connected from U.S. sources if the services were performed in the United States.

Interest deductions of foreign corporations are subject to a detailed regulatory regime for allocation and apportionment to U.S.-effectively connected income (Treas. Reg. sec. 1.882-5). The following three steps are required in the allocation process:

> (1) The corporation's effectively connected assets, such as (in the case of a bank) loans generated with the active and material participation of U.S. branch personnel and administered by the U.S. branch, must be identified and their average total amount must be measured on a consistent basis, using either U.S. tax book value or fair market value, and using spot totals computed at the most frequent, regular intervals for which all asset data are available;
>
> (2) The corporation must impute an amount of debt necessary to fund these effectively connected assets (In the words of the Treasury Regulation, this theoretical portion of the corporation's debt is referred to as its "U.S.-connected liabilities"); and
>
> (3) The corporation must construct one or more average rates of interest expense to associate with the U.S.-connected liabilities.

The deduction equals the product of the imputed debt and the constructed rate, or where the Treasury Regulations provide for subdividing the debt into more than one piece and constructing a separate average rate for each piece, the deduction equals the sum of the products of the pieces of imputed debt and the applicable rates.[10]

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[10] For further details on the above rules, see Joint Committee on Taxation, Background and Issues Relating to the

(Footnote continued)

Income of a foreign bank's foreign office from U.S. sources

Payments of U.S. source interest that is not effectively connected with a U.S. trade or business are subject to 30-percent withholding tax by the general rule of Code sections 871(a)(1)(A) and 881(a)(1). A number of exceptions to this rule exist. For example, original issue discount on obligations maturing in six months or less is exempt from tax (Code secs. 871(a)(1)(A), 871(a)(1)(C), and 881(a)(1)(3)).

Most significantly, the Code exempts from the 30-percent tax certain interest paid on portfolio obligations (Code secs. 871(h) and 881(c)). Portfolio interest generally is defined as any U.S. source interest (including original issue discount), not effectively connected with the conduct of a U.S. trade or business, (1) on an obligation that satisfies certain registration requirements or specified exceptions thereto, and (2) that is not received by a 10-percent shareholder, taking into account shares owned by attribution (Code sec. 871(h)). In the case of a corporate recipient of interest, however, the term portfolio interest generally also excludes any interest received either by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States).

Some U.S. tax treaties provide reciprocal exemptions from withholding tax on payments of interest (as in the case of treaties with France, Germany, the Netherlands and the United Kingdom). Other treaties permit tax, but at reduced rates ranging from five percent (e.g., Switzerland) and 10 percent (e.g., Japan) to 15 percent (e.g., Belgium, Canada and Italy).[11]

4. Character of certain indebtedness

General tax rules applicable to all corporations

Taxpayers generally are allowed a deduction for any loss not compensated by insurance or otherwise (Code sec. 165(a)). Losses from worthless securities may not be deducted as a bad debt (Code sec. 166(e)). If a security that is a capital

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[10](continued)
Taxation of Foreign Investment in the United States (JCS-1-90), January 23, 1990, at 21-22.

[11] The United States generally has terminated its prior tax treaty relationship with the Netherlands Antilles (effective January 1, 1988), but has permitted the provisions of the treaty that exempt interest from withholding tax to remain in effect.

asset becomes worthless during a taxable year, the loss resulting therefrom is treated as a loss from the sale or exchange of a capital asset.[12] For these purposes, "security" means a share of stock in a corporation, a right to subscribe for, or receive, stock, or a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form (Code sec. 165(g)(2)).

The characterization of a security as a capital asset is important because the loss on the sale or exchange of a capital asset by a corporation is deductible only to the extent of gains from such sales or exchanges (Code sec. 1211). Corporate net capital losses generally may be carried back 3 years and forward 5 years (Code sec. 1212). Capital assets generally are defined as property other than stock in trade or inventory of the taxpayer, depreciable property or real estate, certain self-created artistic or similar property, accounts receivable acquired from the sale of stock in trade or inventory, and certain publications of the U.S. Government (Code sec. 1221). Thus, most securities held by a taxpayer generally would be considered capital assets unless the taxpayer is considered to be a dealer in such securities (Code sec. 1236).[13]

Special rules applicable to commercial banks

Banks and certain other financial institutions may deduct as a bad debt any debt that is evidenced by a security that becomes wholly or partially worthless during the taxable year. In addition, the sale or exchange of a bond, debenture, note, or certificate or other evidence of indebtedness by a bank and or certain other financial institutions is not treated a sale or exchange of a capital asset (Code sec. 582).[14] Thus, losses on the sale, exchange, or worthlessness of debts held by banks and certain other

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[12] Securities in a certain affiliated corporations are not treated as capital assets. Qualified affiliated corporations generally are those in which the taxpayer owns 80 percent or more of the stock and which derive 90 percent or more of its aggregate gross receipts from active sources (Code sec. 165(g)(3)).

[13] In addition, certain property used in a hedging transaction is not considered to be a capital asset. The extent of, and what types of property qualify for, the hedging exception under present law is unclear. Compare Arkansas Best v. Commissioner, 108 S. Ct. 971 (1988) with Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955).

financial institutions are treated as securities and are not subject to the capital loss limitations, even if such securities are held for investment, rather than trade or business, purposes.

5. Net operating loss carryovers

General tax rules applicable to all corporations

A net operating loss is the excess of the deductions allowed for a taxable year over the gross income for the year. The net operating loss of a corporation for a taxable year generally can be carried back 3 years and carried forward 15 years. The taxpayer may elect to waive the carryback of a net operating loss (Code sec. 172).[15]

Special rules applicable to commercial banks

In the case of a large bank, the portion of any net operating loss incurred in any taxable year beginning after December 31, 1986, and before January 1, 1994, that is attributable to a bad debt deduction may be carried back 10 years and forward 5 years. The portion of a net operating loss that is attributable to a bank's bad debt deduction is the excess of net operating loss over the amount of the net operating loss determined without regard to the bad debt deduction for the year.

6. Common trust funds

General tax rules

The taxation of an entity and its owners depends upon the characteristics of entity. A subchapter C corporation generally is subject to corporate-level tax and its

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[14] For this purpose, any regular or residual interest in a REMIC is treated as an evidence of indebtedness.

[15] A net operating loss of a corporation may be used in other ways. For example, if a corporation elects to file a consolidated return with another corporation, the net operating loss of one corporation may offset the taxable income of the other corporation. Includible corporations in the same affiliated group may elect to file a consolidated return (Code sec. 1501). In general, one corporation is affiliated with another if the first corporation owns 80 percent of the vote and value of the stock of the second corporation (Code sec. 1504). Limitations are placed upon the use of losses that arise in one corporation before such corporation enters into the consolidated group (Code secs. 382 and 384; Treas. Reg. secs. 1.1502-21 and 1.1502-79).

shareholders are subject to tax on distributions from the corporation. Partnerships and subchapter S corporations generally are not subject to entity-level tax; instead, the items of income, deduction, and loss flow-through to the owners of such entities. Trusts generally are subject to tax on the items of net income that are not distributed or required to be distributed to beneficiaries; trust beneficiaries are subject to tax on amounts distributed or required to be distributed. Certain trusts (grantor trusts) are not subject to tax; instead, the items of income, deduction, and loss flow-through to the owners of the trusts. A grantor trust basically is a trust where the grantor retains certain interests in or over the trust.

Special rules applicable to commercial banks

The common trust fund of a bank is not subject to tax and is not considered to be a corporation. A common trust fund is a fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, guardian, or certain custodian and in conformity with rules and regulations of the Board of Governors of the Federal Reserve System or the Comptroller of the Currency pertaining to the collective investment of trust funds by national banks (Code sec. 584(a) and (b)).

The income of a common trust fund is computed in the same manner and on the same basis as is an individual's, except that (1) all items of gain or losses from the sale of capital assets are segregated and computed separately, (2) ordinary income or loss is computed following the segregation of items of capital gain or loss, and (3) charitable deductions are not allowed. The income of the fund flows-through to the participants of the fund on proportional basis, whether or not such income is distributed or distributable (Code sec. 584(c) and (d)). The taxable year of a common trust fund is the calendar year; thus, participants include their proportionate shares of the items of the fund in the taxable year that includes or ends with the fund's taxable yearend (Code sec. 584(f) and (h)).

No gain or loss is realized by the fund upon admission or withdrawal of a participant. Participants generally treat their admission to the fund as the purchase of such interest. Withdrawals from the fund generally are treated as the sale of such interest by the participant (Code sec. 584(e)). Although unclear, if a common trust fund were to lose its status as such, the participants in the fund might be treated as having withdrawn from the fund. In such case, the participants may be treated as having withdrawn their respective shares of the fund's underlying assets and contributed such assets to another entity.[16] The deemed withdrawal from the fund would presumably subject the

participants to tax on the unrealized appreciation in the assets of the fund.

C. Tax Treatment of Thrift Institutions

Domestic building and loan associations, domestic savings and loan associations, Federal savings and loan associations, mutual savings banks, cooperative banks, and similar institutions (collectively known as "thrift institutions") generally are institutions the business of which consists principally of acquiring the savings of the public and investing in loans (primarily residential real estate mortgages). Thrift institutions generally are subject to supervision and examination by state or Federal authorities. Some thrift institutions are corporations whose shares are held by shareholders who may or may not have deposited amounts in the institution; other thrift institutions are operated as mutual or cooperative entities in which cases the owners and depositors of the institution are same persons.

Thrift institutions are similar to commercial banks in that both types of entities collect interest-earning deposits from, and make loans to, the public.[17] In addition, thrift institutions, like banks, are subject to regulation and supervision by governmental agencies and are generally subject to Federal income tax as a corporation.[18] However, some of the Federal income tax rules that apply to thrift institutions are not only different than those that apply to other corporations, they also are somewhat different from the rules that apply to banks. Among the special rules that apply to thrift institutions are: (1) the treatment of bad debt reserves; (2) the deductibility of dividends paid on deposits; and (3) the treatment of property foreclosures.

In addition, some of the special tax rules that apply to

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[16] The Federal income tax treatment of such entity would depend on the characteristics of the entity. For example, it is possible that the entity could be treated as a partnership, corporation, or RIC.

[17] However, thrift institutions generally are encouraged to make residential real estate mortgages by the Code granting more favorable tax treatment (discussed below) if the institution invests in residential real estate mortgages.

[18] Prior to 1952, mutual savings banks, cooperative banks, domestic building and loan associations and other savings institutions chartered and supervised as a savings and loan or similar institution under Federal or state law were not subject to Federal income tax.

banks (as discussed in the prior section) apply in different ways to thrift institutions. In addition, thrift institutions have bad debt deduction rules (discussed in detail below) that are more liberal than the special rules that are applicable to banks. On the other hand, the expanded carryover period of bank net operating losses[19] and the special rules for common trust funds of banks do not apply to thrift institutions. Further, the special rules regarding the treatment of interest expense on debt used to purchase or carry tax-exempt obligations, the foreign income rules, and the characterization of certain indebtedness as ordinary income property apply equally to banks and thrift institutions.[20]

1. Bad debt reserves

Thrift institutions generally are granted more favorable tax treatment in the computation of their bad debt deductions than banks or other taxpayers if their assets meet certain requirements. Thrift institutions whose assets do not meet these requirements are subject to the same tax treatment in the computation of their bad debt deductions as banks.

Thrift institutions holding 60-percent qualifying assets

If a thrift institution holds 60 percent of its assets in so-called "qualifying assets" (generally cash, government obligations, and loans secured by residential real property), the institution is eligible to compute the deductible additions to its bad debt reserve under either the specific charge-off method or the reserve method. If such a thrift institution uses the reserve method of accounting for bad debts, it may elect each year to calculate its annual addition to its bad debt reserve under modified versions of either the experience method used by small banks or the "percentage of taxable income" method (Code sec. 593(b)). In determining the amount of an allowable loan loss deduction, special rules apply with respect to "qualifying real property

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19 Prior to the Tax Reform Act of 1986, the carryover periods for the net operating losses of banks and thrift institutions were the same (back ten years and forward five years). The 1986 Act preserved these periods for certain banks through taxable years beginning in 1993. However, net operating losses incurred by thrift institutions in taxable years beginning after 1985 are subject to the carryover periods applicable to most corporations (back 3 years and forward 15 years).

20 In general, these rules also may apply to financial institutions that are neither banks or thrift institutions.

loans" and "nonqualifying loans." In general, a qualifying real property loan is any loan secured by an interest in improved real property or secured by an interest in real property that is to be improved out of the proceeds of the loan. A nonqualifying loan is any loan which is not a qualifying real property loan. (Code sec. 593(d)).

Under the percentage of taxable income method, a thrift institution is allowed a deduction for additions to its loan loss reserve equal to 8 percent of its taxable income (subject to certain adjustments) for the taxable year.[21] However, limitations apply to the addition to the reserve. First, the amount determined under the percentage of taxable income method must be reduced (but not below zero) by the amount of the loan loss addition for that taxable year determined under the experience method with respect to nonqualifying loans. A thrift institution using the percentage of taxable income method is entitled to a deductible addition to a reserve for losses on nonqualifying loans calculated under the experience method in addition to the amount based on taxable income. Second, the addition to the reserve for qualifying real property loans may not exceed the amount necessary to increase the balance of such reserve at the close of the taxable year to more than 6 percent of such loans outstanding at the close of the taxable year. Third, the overall bad debt reserve addition cannot (including the experience method allowance related to nonqualifying loans) exceed the greater of: (1) the amount determined under the experience method, or (2) the excess of 12 percent of total deposits or withdrawable accounts of depositors at the close of the taxable year over the sum of surplus, undivided profits, and reserves at the beginning of the taxable year.

In general, when a thrift institution makes a distribution to its shareholders out of excess bad debt reserves (i.e., in general, the excess of the reserve for losses on qualifying real property loans over the reserve which would have been allowable under the experience method), it must report that amount as income[22] (Code sec. 593(e)).

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[21] One such adjustment relates to net operating losses. Treasury regulations provide that taxable income, for purposes of the percentage of taxable income method, is to be reduced by net operating losses carried over from another taxable year. Treas. Reg. sec. 1.593-6(b)(2)(iv). However, in Pacific First Federal Savings Bank v. Commissioner, 94 T.C. 101 (1990), the U.S. Tax Court ruled such regulation invalid.

[22] This recapture rule does not apply, however, to certain
(Footnote continued)

The percentage of taxable income method subjects thrift institutions to tax on only part (92 percent) of their income. In exchange for this benefit, present law imposes limitations upon some of the otherwise allowable deductions and credits of thrift institutions. Thrift institutions are entitled to only one-half of the targeted jobs tax credit available to taxpayers generally (Code sec. 52(e)). In addition, although corporations generally are entitled to a deduction of 70 percent (80 percent or 100 percent in certain circumstances) of all dividends received from domestic corporations, thrift institutions using the percentage of taxable income method must reduce by 8 percent the amount of the dividends received deduction (Code sec. 596). Further, the amount by which the deduction for an addition to a bad debt reserve exceeds the amount that would have been allowable as a deduction under the experience method is a preference item under the alternative minimum tax (Code sec. 57(a)(4)).

Thrift institutions not holding 60-percent qualifying assets

If a thrift institution does not hold 60 percent of its assets as qualifying assets, the entity generally is treated as a commercial bank if it otherwise satisfies the definition of a bank in section 581 (Code sec. 585(a)(2)). If the adjusted bases of the assets of the institution (or any controlled group of which the institution is a member) exceed $500 million, the institution may be considered to be a large bank and may be ineligible to use the reserve method of computing deductions for losses on bad debts (i.e., it must use the specific charge-off method). The existing bad debt reserve of the former thrift institution may be subject to recapture. If the adjusted bases of the assets of the entity do not exceed $500 million, the entity may be considered a small bank and may be eligible to use either the specific charge-off method or the experience method.

2. Deductibility of dividends by thrift institutions

Mutual thrift institutions are allowed a special deduction in determining their taxable income for amounts paid or credited to the accounts of depositors or holders of withdrawable accounts (Code sec. 591). Because these amounts are in the nature of interest, this deduction is allowed regardless of whether the amounts are denominated as dividends or interest. In order to be deductible, however, such amounts must be withdrawable on demand, subject only to the customary notice of intention to withdraw. Thus, amounts

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[22](continued)
distributions in redemption of an interest in a thrift institution received in exchange for financial assistance.

paid as a dividend on the non-withdrawable capital stock accounts of a savings and loan association or a mutual savings bank are not deductible. Such a nondeductible dividend is treated as a distribution with respect to stock as it is in the case of any other corporation.

The deduction for amounts credited as dividends or interest by thrift institutions is allowed in the taxable year in which such amounts become withdrawable by the depositor or account holder.

3. Foreclosure of property securing loans

In general

Foreclosure by a creditor on property in which the creditor holds a security interest is a taxable event to the creditor[23] (Treas. Reg. sec. 1.166-6). First, the creditor may realize a deductible bad debt loss on the foreclosure if part or all of the debt foreclosed upon is worthless. Second, if the creditor acquires the property at the foreclosure sale, the creditor is treated as disposing of the debt in exchange for the fair market value of the property foreclosed upon. Thus, the creditor may recognize gain or loss on the foreclosure if the property received has a fair market value more or less than his basis in the amount of the underlying debt. The creditor takes a basis in the acquired property equal to its fair market value. Later, if the property is disposed of in a taxable event, additional gain or loss may be recognized.

Special rules for thrift institutions

If a thrift institution forecloses on the security for a debt owed to the institution (or otherwise reduces the property to ownership or possession by any process of law or by agreement), no gain or loss is recognized and no debt is considered as having become wholly or partially worthless regardless of the property's fair market value at the time of the foreclosure (Code sec. 595). Thus, the loan transaction is held open and the property received in the foreclosure (or other proceeding) is treated for Federal income tax purposes as having the same characteristics as the debt for which it was security.[24] The thrift institution's basis in the

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[23] However, no gain or loss generally is recognized by a seller-mortgagee on the reacquisition of real property in which the a seller-mortgagee had taken an indebtedness on original sale (Code sec. 1038).

[24] Thus, no depreciation deductions are allowable with respect to the acquired property.

acquired property is equal to its adjusted basis in the debt, increased by the costs of acquisition.

While, under this provision, the acquisition of the security by foreclosure (or other legal means) is not itself a taxable event to a thrift institution, foreclosure may still have tax effects in the taxable year of foreclosure or later taxable years. For example, if the property foreclosed upon has declined in value below the thrift institution's basis in the property (generally, the amount of the debt outstanding at the time of the foreclosure, adjusted for acquisition costs), the decline may be charged against the bad debt reserve of the institution (if that is proper under the institution's method of accounting), and the basis of the property is reduced accordingly. If the property continues to decline in value, further bad debt deductions may be taken. When the property is later disposed of, the amount realized is treated as a payment on the debt thereby closing the transaction.

D. Tax Treatment of Life Insurance Companies

Life insurance companies are primarily engaged in the issuance of life insurance contracts, annuity contracts, guaranteed investment contracts, and noncancellable or guaranteed renewable accident and health insurance contracts. The premiums and other consideration received by a life insurance company are pooled by the company for investment purposes until such time as a payment is required under the terms of a contract. Special Federal income tax rules apply to life insurance companies and to the owners and beneficiaries of life insurance contracts and annuity contracts.

1. Taxation of life insurance companies

Definition of life insurance company

For Federal income tax purposes, a life insurance company is defined as an insurance company that is engaged in the business of issuing life insurance contracts, annuity contracts, or noncancellable accident and health insurance contracts if more than 50 percent of the total reserves of the company are (1) life insurance reserves and (2) unearned premiums and unpaid losses on noncancellable life, accident, or health insurance contracts that are not included in life insurance reserves.

Reserve deduction

A life insurance company is subject to tax at corporate rates on its taxable income. Unlike deposits received by a bank or thrift institution, the gross amount of premiums and

other consideration received by a life insurance company is includible in the gross income of a life insurance company. A life insurance company, however, is allowed a deduction for any net increase in life insurance reserves and must include in gross income any net decrease in life insurance reserves.

The life insurance reserve for any contract generally is the greater of the net cash surrender value of the contract or the reserve for the contract determined under Federally prescribed rules. The reserve determined under the Federally prescribed rules is designed to approximate the amount needed to fund the excess of (1) the present value of future claims and benefits to be paid under the contract, over (2) the present value of the future premiums, if any, to be received under the contract.

The reserve deduction of a life insurance company offsets the inclusion in gross income of the portion of the premium or annuity consideration that is the equivalent of a deposit received by a bank or thrift institution (which is not included in the gross income of a bank or thrift institution). In addition, the reserve deduction offsets the inclusion in gross income of the investment income of a life insurance company that is credited to a contract much like the deduction that is allowed a bank or thrift institution for interest credited to a depositor's account. Unlike the treatment of a bank or thrift institution, however, the reserve deduction of a life insurance company may offset other income of the company if the Federally prescribed reserve for a contract exceeds the net cash surrender value of the contract.

Small company deduction

A small life insurance company is allowed a special deduction equal to 60 percent of so much of the tentative life insurance company taxable income for a taxable year as does not exceed $3 million, reduced by 15 percent of the excess of the tentative life insurance company taxable income over $3 million. The small life insurance company deduction is only available to a life insurance company with gross assets of less than $500 million.

Treatment of tax-exempt interest

Like other taxpayers, a life insurance company is not subject to tax on interest from State and local bonds to the extent that the interest is otherwise excludable under the Code. In order to prevent a double benefit, however, a life insurance company is required to reduce the closing balance of its reserves to the extent that the reserves are funded by tax-exempt interest. The amount of the reduction equals the policyholders' share of the tax-exempt interest of the life insurance company.

Treatment of mutual life insurance companies

A life insurance company is allowed a deduction for the amount of policyholder dividends paid or accrued during a taxable year. In the case of a mutual life insurance company, the amount of the deduction for policyholder dividends is reduced by a "differential earnings amount." If the differential earnings amount exceeds the allowable deduction for policyholder dividends, then the excess reduces the closing balance of the company's reserves.

Treatment of policy acquisition expenses

Life insurance companies generally are required to amortize policy acquisition expenses for any taxable year on a straight-line basis over a 120-month period that begins with the first month in the second half of the taxable year. Policy acquisition expenses are defined for each of several categories of specified insurance contracts as a percentage of total net premiums for that category of contract. The separate categories and the percentages for each of the categories are as follows:

Annuity contracts	1.75 percent
Group life insurance contracts	2.05 percent
Other specified insurance contracts	7.70 percent

The amount of policy acquisition expenses for any taxable year, however, may not exceed the amount of certain specified deductions of the insurance company for such taxable year. A specified insurance contract generally is defined as any life insurance contract, annuity contract, or noncancellable or guaranteed renewable accident and health insurance contract.

A shorter amortization period of 60 months rather than the generally applicable 120 months is provided for the first $5 million of policy acquisition expenses of an insurance company for any taxable year. The availability of the 60-month amortization period is phased out ratably (on a dollar-for-dollar basis) as policy acquisition expenses increase from $10 million to $15 million.

Consolidated return limitations

A domestic life insurance company that is a member of an affiliated group which includes corporations other than life insurance companies is not allowed to join in the filing of a consolidated return for the group unless the life insurance company has been a member of the affiliated group for the 5 taxable years immediately preceding the taxable year for which the consolidated return is filed. If the members of such an affiliated group are allowed to file a consolidated return, the amount of any consolidated net operating loss of

the corporations that are not life insurance companies may reduce the income of the members that are life insurance companies only to the extent of the lesser of (1) 35 percent of the net operating loss, or (2) 35 percent of the taxable income of the members that are life insurance companies. Furthermore, the net operating loss of a corporation that is not a life insurance company may not reduce the income of an affiliated life insurance company if the net operating loss arose in a taxable year that precedes the sixth taxable year that the corporation and the insurance company have been members of the same affiliated group.

2. Taxation of owners and beneficiaries of life insurance contracts and annuity contracts

Life insurance contracts

Unlike the treatment of interest credited to a depositor's account, the undistributed investment income ("inside buildup") earned on premiums credited under a contract that satisfies a statutory definition of life insurance is not subject to current taxation to the owner of the contract. In addition, death benefits paid under a contract that satisfies the statutory definition are excluded from the gross income of the recipient, so that neither the owner of the contract nor the beneficiary of the contract is ever taxed on the inside buildup if the proceeds are paid to the beneficiary by reason of the death of the insured.

Amounts received under a life insurance contract (other than a modified endowment contract) prior to the death of the insured generally are not includible in gross income to the extent that the amount received does not exceed the taxpayer's investment in the contract. Amounts borrowed under a life insurance contract (other than a modified endowment contract) generally are not treated as received and, consequently, are not includible in gross income.

Annuity contracts

In the case of an annuity contract that is owned by an individual, the inside buildup under the contract is not subject to current taxation to the owner of the contract. In the case of an annuity contract that is owned by a person other than an individual, the inside buildup under the contract generally is treated as ordinary income received or accrued by the owner of the contract.

Amounts received under an annuity contract prior to the annuity starting date generally are includible in gross income to the extent that the cash surrender value of the contract exceeds the taxpayer's investment in the contract. In addition, a 10-percent additional tax generally is imposed on amounts includible in gross income if the distribution

occurs prior to the date that the owner of the contract attains age 59-1/2.

In the case of amounts received as an annuity (i.e., as a series of substantially equal payments over a specified period) under an annuity contract, a portion of each payment is excludable from gross income as a return of the taxpayer's investment in the contract and the remainder is subject to tax as ordinary income. The amount that is excludable from gross income is determined on the basis of an exclusion ratio, the numerator of which is the taxpayer's investment in the contract and the denominator of which is the expected return under the contract.

E. Tax Treatment of Other Entities Engaged in Financial Activities

Certain other entities may engage in activities similar to the activities engaged in by banks and thrift institutions--namely, the collection of investment funds from the public or the making of loans. The special Federal income tax rules that apply to banks and thrift institutions (as described above) generally do not apply to such entities. On the other hand, special Federal income tax rules may apply to such entities, but not to banks or thrift institutions. Following is a description of some entities that may be viewed as engaging in the collection of investment funds or the making of loans, and the Federal income tax treatment applicable to such entities.

1. Credit unions

Federally-chartered and State-chartered credit unions are exempt from Federal income tax regardless of whether or not income is distributed to members as dividends. Federally-chartered credit unions are exempt pursuant to section 122 of the Federal Credit Union Act and Code section 501(c)(1); Stated-chartered credit unions are exempt pursuant to Code section 501(c)(14)(A).

2. Regulated investment companies

Most mutual fund and money market funds generally are taxed as regulated investment companies (RICs). In general, a RIC is a domestic corporation which, at all times during the taxable year, is registered under the Investment Company Act of 1940 as management company or unit investment trust, or has in effect an election under such act to be treated as a business development company, or is a common trust fund or similar fund excluded by section 3(c)(3) of such Act from the definition of an "investment company" and is not defined as a common trust fund under Code section 584(a). In addition, in order to be considered a RIC for Federal income tax purposes, the corporation must elect such status and derive at least 90 percent of its gross income from certain passive sources, cannot derive 30 percent or more of its gross income from the sale or disposition of certain assets held for less than 3 months, and must have certain prescribed amounts of diversification in its investments (Code sec. 851).

A RIC is subject to corporate income tax on its investment company taxable income. Investment company taxable income is the RIC's taxable income, adjusted for certain items. In computing investment company taxable income, RICs are not allowed the deductions normally allowed to corporations for net operating loss carryovers or dividends received, but are allowed deductions for dividends

paid to shareholders. In order for the tax treatment described above to apply, a RIC generally must distribute at least 90 percent of its pre-distribution investment company taxable income for the year (Code sec. 852). For these purposes, certain dividends distributed by a RIC in the 12-month period after the close of a taxable year may be considered to be distributed in the taxable year (Code sec. 855).

Shareholders of RICs generally are subject to tax on dividends from RICs. The character of certain items of income of a RIC retain their character when distributed to shareholders. For example, shareholders treat capital gain dividends as gain from the sale or exchange of a capital asset held more than one year and treat exempt-interest dividends as an item of tax-exempt interest (Code secs. 852(b)(3) and (5)). Shareholders are normally subject to tax on dividends in the year the dividends are received. However, RIC dividends declared in any of the last three months of a calendar year, that are payable to shareholders of record in such a month, and are paid during January of the following calendar year are treated as distributed on December 31 of the calendar year in which the dividend was declared (Code sec. 852(b)(7)).

3. Real estate investment trusts

Real estate investment trusts (REITs) are sources of financing for transactions involving real estate. A REIT is a corporation, trust, or association that is managed by one or more trustees or directors; the beneficial ownership of which is evidenced by transferable shares or certificates; that would normally be treated as a taxable as a domestic corporation; that is not a bank, thrift institution, small business investment company, business development corporation, or life insurance company; has 100 or more beneficial owners; is not closely held; makes an election to be treated as such; and meets certain income thresholds. A REIT must derive at least 95 percent of its gross income from certain passive sources; at least 75 percent of its gross income from certain real estate-related sources; and less than 30 percent of its gross income from sales or dispositions of certain property, and must hold at least 75 percent of its assets in real estate, cash, cash equivalents and Government securities (Code sec. 856).

A REIT is subject to corporate income tax on its real estate investment trust taxable income. Real estate investment trust taxable income is the REIT's taxable income, adjusted for certain items. In computing real estate investment trust taxable income, REITs are not allowed the deduction normally allowed to corporations for dividends received, must exclude net income from foreclosure property, and are allowed deductions for dividends paid to

shareholders. In order for the tax treatment described above to apply, a REIT generally must distribute at least 95 percent of its real estate investment trust taxable income (Code sec. 857). For these purposes, certain dividends distributed by a REIT in the 12-month period after the close of a taxable year may be considered to be distributed in the taxable year (Code sec. 858).

Beneficial owners of REITs generally are subject to tax on dividends from REITs. The character of certain items of income of a REIT retain their character when distributed to beneficial owners. For example, beneficial owners treat capital gain dividends as gain from the sale or exchange of a capital asset held more than one year (Code sec. 857(b)(3)). Beneficial owners are normally subject to tax on dividends in the year the dividends are received. However, REIT dividends declared in December of a calendar year, that are payable to shareholders of record in such month, and are paid during January of the following calendar year are treated as distributed on December 31 of the calendar year in which the dividend was declared (Code sec. 857(c)(8)).

4. Real estate mortgage investment conduits

A real estate mortgage investment conduit (or REMIC) is any entity that elects to be treated as such, all the interests of which are regular interests or residual interests, has only one class of residual interests, invests substantially in qualified mortgages and other permitted investments, which has a calendar year as its taxable year, and which makes reasonable arrangements to insure that disqualified organizations (generally certain tax-exempt entities) do not invest in residual interests (Code sec. 860E). A REMIC is not subject to tax and is not treated as a corporation, partnership, or trust for Federal income tax purposes (Code sec. 860A). Instead, the income of a REMIC is taxed to the holders of the REMIC interests, depending on the type of interest held. Holders of regular interests generally treat such interests as debt instruments (Code sec. 860B). Holders of residual interests generally take into account their daily portion of the taxable income or loss of the REMIC (Code sec. 860C).

5. Small business investment companies

The Small Business Investment Act of 1958 (15 U.S.C. 661, et. seq., "the Act") authorizes the licensing of small business investment companies (SBICs). SBICs are privately-owned corporations and limited partnerships. They are intended by the Act to supply equity capital, loans, and management assistance to qualifying small business concerns. The Small Business Administration has authority to determine what types of entities qualify as small business concerns.

Subject to certain limitations, the Small Business Administration may purchase or guarantee debentures of an SBIC. Such guarantees carry the full faith and credit of the United States. In addition, an SBIC owned in whole or in part by a bank is permitted to make investments that the bank itself is not permitted to make under present banking law.

SBICs organized as corporations or limited partnerships generally are subject to Federal income tax in the same manner as are corporations or limited partnerships that are not SBICs, with exceptions for certain particular items. For example, dividends received by an SBIC are allowed a 100 percent dividends received deduction (Code sec. 243(a)(2)). Losses on certain investments in, and of, SBICs are treated as ordinary, rather than capital, losses (Code secs. 582, 1242, and 1243).

6. Other sources of consumer credit

Consumers may seek credit from entities that are not banks or thrift institutions. For example, major U.S. automobile manufacturers have established finance subsidiaries that help consumers finance the purchase of new automobiles. Likewise, many retail stores offer credit cards to their customers for use in purchasing goods from such stores. Further, some sellers of consumer goods and services offer credit cards that can be used to purchase goods and services from any number of unrelated vendors (e.g., the Sears Discover card and the AT&T Universal card are general purpose credit cards.)

The Federal income tax rules that apply to most corporations generally apply to finance subsidiaries that do not qualify as banks or thrift institutions. The special rules that apply to banks or thrift institutions generally do not apply to such entities. For example, finance subsidiaries must use the specific charge-off method for computing deductions for bad debts and may not use the reserve methods applicable to small banks or thrift institutions.

III. PRINCIPAL ISSUES TO THE WAYS AND MEANS COMMITTEE RAISED BY H.R. 1505

The following are the principal tax and debt management issues raised by H.R. 1505:

(1) Use of social security numbers to enforce deposit insurance limitations.--One principal issue is whether the use of taxpayer identification numbers (i.e., social security numbers) is necessary to enforce any limitations on the amount of deposit insurance. A related issue is whether any limitations should be placed on the FDIC on its use of taxpayer information (e.g., the depositor's tax return) to substantiate the number of accounts owned by the taxpayer.

(2) Provision of additional FDIC financing.--The borrowings by the FDIC under the proposed legislation raise three basic questions: (a) what is the effect of those borrowings on the overall borrowings subject to the Federal debt limit; (b) would the borrowing methods prescribed by the proposed legislation result in the lowest cost means of achieving such borrowings; and (c) what is the risk of loss to the Federal Government from these borrowings, especially in light of the limit on additional bank insurance premiums under the bill. A related issue is whether it would be better for the borrowings to be made in a way that is subject fully to the Federal debt limit.

(3) Transfers to common trust funds.--The principal issue raised by H.R. 1505 concerning common trust funds is whether the Federal tax laws should be modified to permit the assets of a common trust fund to be transferred on a tax-free basis to a regulated investment company ("mutual fund"). A subsidiary issue is whether any such relief, if granted, should be limited to situations where the transfer does not result in the participants in the common trust fund receiving significant diversification of their investments on a tax-free basis.

(4) Competition between banks and other types of financial intermediaries.--The major competitive issues raised by H.R. 1505 are: (a) is there competition between banks and other types of taxpayers under present law; (b) would certain of the provisions of H.R. 1505 increase or decrease the competition between such types of taxpayers; and (c) if certain provisions of H.R. 5105 are enacted, do the differences in tax treatment between competing types of taxpayers create unacceptable competitive advantages and disadvantages between competing taxpayers such that more uniform tax rules should be provided.

(5) Broader bank powers and use of consolidated returns.--One issue is whether it is appropriate to permit or limit the ability of holding companies to offset the incomes

and losses of banks and affiliated companies of holding companies allowed by H.R. 1505 through the use of consolidated returns. A second related issue is whether the use of losses of a bank to offset the income of non-bank affiliates through consolidated returns (that may be viewed as a loan of the bank's tax benefits) undercuts the "firewall" provisions of H.R. 1505. A third issue is whether the present-law restrictions on the inclusion of insurance companies in a consolidated income tax return are appropriate.